No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INC. ET AL.,

Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE STATES OF ARKANSAS, MICHIGAN, MISSISSIPPI, MISSOURI, NEW JERSEY, NEW MEXICO, AND RHODE ISLAND, AND THE COMMONWEALTH OF MASSACHUSETTS, AND THE PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM AND THE PENNSYLVANIA STATE EMPLOYEES' RETIREMENT SYSTEM AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF AMICUS CURIAE[1]

The Amici States, as guardians of the citizenry and as fiduciaries to the public servants who rely on them to prudently manage their retirement funds, have a paramount interest in the enforcement and proper interpretation of the securities laws. The Amici States, by their own laws, also give recognition to and confer both rights and responsibilities on corporations. Thus, the method for pleading scienter under the securities laws is of great importance to the Amici States.

The Amici States, and the Amici public pension funds, manage an aggregrate $400 billion invested in the public markets, and are among the largest public or private money managers in the United States. Combined, they manage the retirement plans for over 3.2 million active and retired public servants. Increasingly, the Amici States and public pension funds act as lead plaintiffs in securities class actions, and in the aggregate currently serve as lead plaintiffs in 26 pending securities class actions. As lead plaintiffs, Amici play a pivotal role in enforcing and deterring violations of the securities laws and in recovering losses for investors and pensioners victimized by fraud. As large public institutional investors, Amici are especially effective lead plaintiffs, just as Congress contemplated when revising the procedures for selecting lead plaintiffs as part of the Private Securities Litigation Reform Act of 1995.

The Court's decision in this case will greatly impact the Amici States' ability to fulfill their dual role as protectors of the public interest and fiduciaries of publicly managed funds.

INTRODUCTION

In 1995, Congress substantially revised the procedures governing the conduct of private securities litigation to minimize

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[1] Amici state that no counsel for any party authored this brief in whole or in part, and no person or entity other than amicus curiae, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. The parties' letters of consent to the filing of this brief have been lodged with the Clerk.

certain perceived abuses while still allowing meritorious claims to proceed. Among other significant changes, Congress tightened the pleading standards for complaints alleging securities fraud, requiring plaintiffs to allege facts "giving rise to a strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). The "strong inference" standard had first been created by the Second Circuit in 1979, and had been consistently interpreted by that court to mean facts sufficient to support a jury verdict for the plaintiff.

Although Congress imported the Second Circuit's language into the new statute and evinced its awareness of Second Circuit pleading requirements, Petitioners and their amici contend that the statutory "strong inference" requirement does not mirror the one created by the Second Circuit at all, but instead represents an entirely new pleading standard – one that has never been employed by any court, that appears nowhere in the legislative history, and that represents a radical departure from the pleading rules that have governed all federal cases since the adoption of the Federal Rules of Civil Procedure. Indeed, the standard proposed by Petitioners appears to have been invented out of whole cloth, for they do not cite a single authority to support their novel formulation. As for Amicus United States, its views on this matter appear to have evolved; in 1998 and 1999, the Securities and Exchange Commission argued before at least five courts of appeals that Congress codified the Second Circuit standard.

The arguments of Petitioners and their amici should be rejected. By its terms, the statute adopts Second Circuit law, and nothing in either the language or the legislative history suggests that Congress intended the drastic new regime that Petitioners and their amici propose. Though Petitioners argue that their new standard is necessary to avoid frivolous litigation, they do not even address why the Second Circuit's standard – identical to the standard sufficient to support a verdict at trial – when combined with the other provisions of the PSLRA, will not accomplish this result. Moreover, Petitioners' proposed standard would have the perverse effect of requiring courts to dismiss meritorious lawsuits. Congress could not have intended such a result.

I. THE PSLRA RELIES ON SEVERAL PROVISIONS TO EFFECTUATE ITS GOALS

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 77z-1 to 78u-5. The Act was designed to minimize certain perceived abuses in securities litigation while simultaneously allowing meritorious cases to go forward. As Congress explained,

> Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.

H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 31, at 31 (1995).

To eliminate frivolous litigation while preserving meritorious actions, Congress created a carefully balanced scheme that made several significant changes to securities litigation procedures, only one of which tightened the requirements for pleading the element of scienter. A proper interpretation of the scienter pleading standard must therefore take into account the fact that this provision is *not* the only protection that defendants have against baseless claims, as well as the fact that Congress did not intend to raise the pleading bar so high that legitimate claims would become impossible to pursue. *See Helwig v. Vencor, Inc.* 251 F.3d 540, 553 (6th Cir. 2001) (en banc) ("[T]he Reform Act would hardly serve its purpose 'to protect investors and to maintain confidence in the securities markets,' were it to become a choke-point for meritorious claims.") (citation omitted); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 30 (1st Cir. 2002) ("The statute was designed to erect barriers to frivolous strike suits, but not to make meritorious claims impossible to bring.").

One of the most significant changes was to eliminate the "race to the courthouse" by creating a set of procedures for determining the lead plaintiff and encouraging the participation of institutional investors, such as pension funds. 15 U.S.C. § 78u-4(a)(3)(B). Congress also placed limits on the use of so-called professional plaintiffs, 15 U.S.C. § 78u-4(a)(3)(B)(vi), and forbade the lead plaintiff from receiving compensation above that received by other class members, 15 U.S.C. § 78u-4(a)(4). Congress believed that these provisions would eliminate attorney-driven litigation and would permit the drafting of stronger, better-researched complaints. *See* H.R. Conf. Rep. No. 369, *supra*, at 32-35; *In re Cavanaugh*, 306 F.3d 726, 738 (9th Cir. 2002).

Next, to eliminate pressures on defendants to settle merely to avoid discovery costs, Congress created a mandatory stay of discovery until the resolution of any motions to dismiss. 15 U.S.C. § 78u-4(b)(3)(B); *see* H.R. Conf. Rep. No. 369, *supra*, at 37. Simultaneously, Congress imposed new pleading standards, requiring that all securities fraud complaints specifically identify false statements, the reasons why they are false, and, for allegations made on information and belief, "state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). Congress tightened the standards for allegations of scienter, as well, requiring that "the complaint . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. §78u-4(b)(2). For claims based on "forward-looking statements," an area believed particularly problematic, *see* H.R. Conf. Rep. No. 369, *supra*, at 42-43, Congress narrowed the substantive bases for liability. Although the circuits were in agreement that proof of recklessness would ordinarily satisfy the scienter element of a §10(b) claim, *see Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003), for forward-looking statements, Congress mandated that plaintiffs prove that the statement was made with "actual knowledge" of its falsity and created a special "safe harbor" for statements

accompanied by proper warnings. 15 U.S.C. § 78u-5. Finally, additional protections were provided at later stages of litigation: limits were placed on joint and several liability, and, at the conclusion of litigation, courts are now statutorily required to assess whether any party has violated Federal Rule of Civil Procedure 11(b). 15 U.S.C. §§ 78u-4(c),(f).

Courts have vigorously enforced the PSLRA's requirements. Despite plaintiffs' lack of access to formal discovery at the pleading stage, courts demand that plaintiffs identify specific internal reports, their contents, and who reviewed them, to show scienter. *See California Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 147 (3d Cir. 2004); *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 72-73 (2d Cir. 2001). In *Goldstein v. MCI WorldCom*, 340 F.3d 238 (5th Cir. 2003), for example, the Fifth Circuit dismissed claims against Bernard Ebbers and Scott Sullivan of Worldcom because, although plaintiffs showed that reports of problems reached several officers and may have been forwarded to Ebbers and Sullivan, there were no particularized allegations that Ebbers and Sullivan read the reports or discussed them with anyone. *See id.* at 251-52.

In sum, the PSLRA contains many provisions that are designed to work in tandem to eliminate frivolous litigation while allowing meritorious claims to proceed. Today, a typical securities fraud complaint is drafted after significant investigation, and it is not uncommon for plaintiffs to track down and interview former employees of the defendant corporation, as was done in this case. Even then, courts often reject allegations as insufficiently sourced. *See, e.g., Teachers' Ret. Sys. v. Hunter*, 2007 WL 509787, at *15-16 (4th Cir. 2007); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 358 (5th Cir. 2002). Therefore, any interpretation of the scienter pleading provision must take into account the other protections against frivolous litigation, or else risk placing unrealistic burdens on plaintiffs bringing meritorious claims. *See ABC Arbitrage*, 291 F.3d at 354 (the PSLRA "was not enacted to raise the pleading burdens ... to such a level that facially valid claims, which are not brought for nuisance value or as

leverage to obtain a favorable or inflated settlement, must be routinely dismissed").

II. THE "STRONG INFERENCE" REQUIREMENT SHOULD BE GAUGED BY A "REASONABLE PERSON" STANDARD

The PSLRA requires plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). The Seventh Circuit construed this language to require that plaintiffs allege sufficient facts to permit a "reasonable person" to conclude that the defendants acted intentionally or recklessly. Pet. App. 20a; *see Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1192 (10th Cir. 2003) ("[T]he ultimate determination as to the plausibility of the competing inference offered by the defendants . . . is for the factfinder."). The Seventh Circuit's interpretation is supported both by the text of the statute and its legislative history.

A. The Plain Text of the Statute Supports the Seventh Circuit's Interpretation

"[W]here words are employed in an act which had at the time a well known meaning in the law, they are used in that sense unless the context requires the contrary." *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 115 (1939); *cf. Douglas v. Seacoast Prods., Inc.*, 431 U.S. 265, 279 (1977) (Court will "assume that Congress was aware of" the judicial interpretation of a statute it has re-enacted and "has ratified the statutory interpretation"); *Bragdon v. Abbott*, 524 U.S. 624, 645 (1998) (same). Because, at the time the PSLRA was passed, it was well-established that facts giving rise to a "strong inference of scienter" were facts sufficient to permit a reasonable jury to find that the defendants had acted with recklessness or intent, a similar construction should be given to the statutory language.

In 1979, the Second Circuit interpreted Federal Rule of Civil Procedure 9(b) to require that plaintiffs "plead those events which they assert give rise to a strong inference" that defendants acted with scienter. *Ross v A.H. Robins*, 607 F.2d 545, 558 (2d Cir. 1979); *see Beck v. Mfs. Hanover Trust Co.*, 820 F.2d

46, 50 (2d Cir.1987). This holding represented a significant tightening of the previous standards for pleading fraud under Rule 9(b), and not all circuits agreed with the Second Circuit's interpretation. *See, e.g., In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545-47 (9th Cir. 1994) (en banc).

The Second Circuit explained that a "strong inference" meant "facts from which one can reasonably infer" scienter. *Cosmas v Hassett* 886 F.2d 8, 13 (2d Cir. 1989); *see Powers v. British Vita, P.L.C.*, 57 F.3d 176, 187 (2d Cir. 1995) (allegations sufficient "to permit a trier of fact to infer intent to defraud"); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 271 (2d Cir. 1993) ("[W]e cannot say, on a motion to dismiss, that the plaintiffs cannot prove that a motive existed. .... Whether some focused preliminary discovery will permit the matter to be resolved adversely to the plaintiffs ... remains to be determined."); *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994) ("[S]ufficient facts were pleaded to suggest that plaintiffs may be able to prove that defendants more likely than not knew that their financial representations were false."); *cf. Wexner v. First Manhattan Co.*, 902 F.2d 169, 172 (2d Cir. 1990) (complaint insufficient because "[t]here is [] no meaningful support from which it can reasonably be inferred that" defendants had scienter); *Kramer v. Time Warner Inc.*, 937 F.2d 767, 172 (2d Cir. 1991) (no strong inference raised because "no reasonable conclusion as to state of mind may be drawn" from facts alleged).

District courts within the Second Circuit also understood the strong inference requirement to be equivalent to a "reasonable person" standard. *See, e.g., In re MTC Elec. Techs. S'holders Litig.*, 898 F. Supp. 974, 989 (E.D.N.Y. 1995); *In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. 686, 693 (S.D.N.Y. 1995); *Drexel Burnham Lambert Group, Inc. v. Microgenesys, Inc.*, 775 F.Supp. 660, 664 (S.D.N.Y. 1991); *Furman v. Sherwood*, 833 F.Supp. 408, 416 (S.D.N.Y.1993). Even outside the Second Circuit, courts following Second Circuit law equated the "strong inference" requirement with a reasonable person standard. *See, e.g., Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (plaintiffs must allege facts that "make it

reasonable to believe" defendants acted with intent; citing the Second Circuit's "strong inference" standard); *In re United Telecomm. Sec. Litig.*, 1992 WL 176430, at *1 (D. Kan. 1992).

Therefore, when the Seventh Circuit adopted a reasonable person standard in this case, it was construing the phrase "strong inference" in accord with the consistent interpretation that has been given to those words in the securities context for nearly 30 years. Because that phrase had a specific, well-defined, and agreed-upon meaning at the time of the PSLRA's passage, Congress must be assumed to have adopted that meaning when it chose to incorporate that language into the statute. *See Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999).

B. Legislative History Shows that Congress Adopted the Second Circuit Standard

The lack of ambiguity in the text of the statute makes resort to the legislative history unnecessary. *See West Virginia Univ. Hosps. v. Casey*, 499 U.S. 83, 98-99 (1991). However, even if one were to consult the legislative history, it is clear that Congress was both aware of and intentionally adopted the Second Circuit "strong inference" standard, believing it to be "the most stringent pleading standard" in the country. H.R. Conf. Rep. No. 369, *supra*, at 41.

i. Congress Understood the Second Circuit's Interpretation of "Strong Inference"

The "strong inference" language first appeared in S. 240, a precursor to the PSLRA. The Senate Banking Committee explained that it had adopted the Second Circuit standard to avoid creating "a new and untested pleading standard that would generate additional litigation." S. Rep. No. 104-98 at 15 (1995). Throughout various revisions, the bill retained the "strong inference" language and, in floor debates regarding the final version, several Conference Committee Managers expressed their understanding that the bill adopted the Second Circuit standard. *See* 141 Cong. Rec. S17,969, S17,959, S17,934, S17,993 (1995).

Amicus United States, reversing the position taken by the Securities and Exchange Commission ("SEC") just eight years ago when the SEC filed briefs in at least five courts of appeals arguing that Congress intended to codify the Second Circuit's standard,[2] now contends that Congress intended to raise the pleading standard above the Second Circuit's formulation. *See* U.S. Br. at 18. Specifically, Amicus relies on the following passage from the Conference Committee report:

> The Conference Committee language is based in part on the pleading standard of the Second Circuit. The standard is also specifically written to conform the language to Rule 9(b)'s notion of pleading with "particularity."
>
> . . . [T]he Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

H.R. Conf. Rep. No. 369, *supra*, at 41. Amicus misinterprets these statements.

As explained above, in addition to requiring that securities fraud complaints create a strong inference of scienter, the PSLRA heightened the *particularity* requirements for pleading scienter. *See* 15 U.S.C. § 78u-4(b)(2). This was a significant change from even the Second Circuit's "stringent" standard, which provided that plaintiffs were obligated to provide only "a minimal factual basis for their conclusory allegations of scienter." *Connecticut*

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[2] *See* Brief of SEC, *In re Silicon Graphics, Inc. Sec. Litig.*, 195 F.3d 521 (9th Cir. 1999) (filed Nov. 1, 1997); Brief of SEC, *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999) (filed Nov. 1997); Brief of SEC, *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir.1999) (filed Feb. 16, 1999); Brief of SEC, *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000) (filed March 11, 1999) and Brief of SEC, *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999) (filed March 16, 1999).

Nat'l. Bank v. Fluor Corp., 808 F.2d 957, 962 (2d Cir. 1987); *see Ouaknine v. MacFarlane*, 897 F.2d 75, 79 (2d Cir. 1990) ("scienter need not be alleged with great specificity"; Rule 9(b) satisfied if plaintiff provides "some factual basis for conclusory allegations of intent"). Therefore, the Conference Report's statement that Congress intended to "strengthen" existing pleading requirements is best understood as referring to the fact that the *particularity* requirements had been enhanced. *Cf. Novak*, 216 F.3d at 310 (PSLRA adopted Second Circuit standard "with the exception of the 'with particularity' requirement"); *Advanta*, 180 F.3d at 534 (same).

Indeed, the fact that Congress chose to heighten the particularity requirements for pleading scienter while retaining the Second Circuit's "strong inference" language is further evidence that Congress endorsed the Second Circuit's "reasonable person" test. As this Court has previously held, the presumption that Congress intended to adopt an established judicial construction of particular language is especially appropriate where, as here, Congress both demonstrated its awareness of the judicial construction, and strategically *departed* from the standard language when that construction was not to its liking. *See Lorillard v. Pons*, 434 U.S. 575, 581 (1978).

ii. The History of the Specter Amendment Does Not Change the Proper Interpretation of Legislative History

Amicus New England Legal Foundation (NELF) contends that Congress's rejection of the Second Circuit's standard is evident from its refusal to adopt a particular amendment proposed by Senator Specter. Even assuming any conclusions can be drawn from the treatment of this single amendment – *see Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 187 (1994) (warning that little can be gleaned from "failed legislative proposals") – Amicus misunderstands the history behind the amendment.

After interpreting Rule 9(b) to require that complaints create a "strong inference" of scienter, the Second Circuit began to articulate

a set of standards for what sorts of facts might create the requisite inference, *see Beck*, 820 F.2d at 50, ultimately concluding that the requisite inference would be raised if plaintiffs alleged facts showing that the defendants had motive and opportunity to commit fraud, or if they alleged facts demonstrating conscious misbehavior or recklessness, *see, e.g., Acito v Imcera Group,* 47 F.3d 47, 53 (2d Cir. 1995). Thus, Senator Specter proposed an amendment to the PSLRA that would have stated that the "strong inference" test could be met through facts alleging motive and opportunity, or conscious misbehavior or recklessness. *See* 141 Cong. Rec. 17,286. The amendment was accepted by the Senate but deleted by the Conference Committee. In so doing, the Committee added a footnote to its statement about not codifying Second Circuit caselaw, writing "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." H. Conf. Rep. No. 369, *supra*, at 48 n.23.

Though Amicus NELF interprets the rejection of the Specter amendment to mean that Congress also rejected the Second Circuit's standard, it overlooks the obvious: As at least three circuits have recognized, it was not always certain what sorts of facts would satisfy the Second Circuit's "strong inference" threshold in the context of "motive and opportunity." *See Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 655-59 (8th Cir. 2001); *Novak*, 216 F.3d at 307; *Bryant*, 187 F.3d at 1286. It is likely for this reason that Congress hesitated to endorse Second Circuit caselaw; indeed, Senator Dodd noted the variation in Second Circuit caselaw, *see* 141 Cong. Rec. S17,960, and Senator D'Amato feared that the Specter amendment imposed *too heavy* a pleading burden on plaintiffs, *see Green Tree*, 270 F.3d at 657 n.9. However, even if Congress was uncertain what facts the Second Circuit believed sufficient to meet the "strong inference" test, nothing in the legislative history suggests that Congress intended to redefine the concept of a "strong inference" itself. *See Green Tree*, 270 F.3d at 659-60 ("The Reform Act itself adopted only the strong-inference-of-scienter standard, without codifying the particular methods

of satisfying the standard.").[3] As the First Circuit put it, "At best, there appears to have been an agreement to disagree on the issue of Second Circuit standards (other than the strong inference standard)." *Greebel*, 194 F.3d at 195.

C. The Phrase "Strong Inference" is Consistent with a "Reasonable Person" Standard

Contrary to the arguments of Petitioners and their amici, a "reasonable person" or "reasonable jury" standard is wholly compatible with the notion of a "strong" inference. Various facts may weigh in favor of a particular conclusion, but still may not reach the point where they are sufficient to support a jury verdict or to meet the party's burden of production. It is only when sufficient facts have been put forth to permit a finding in the plaintiff's favor that the inferences become "strong." *See, e.g., Anaersen v. Liberty Lobby*, 477 U.S. 242, 249 (1986) (to survive summary judgment, plaintiffs must submit evidence that is more than "colorable").

For instance, in *Greenstone*, the First Circuit sustained the dismissal of a securities fraud complaint because it failed to contain sufficient facts to "make it reasonable to believe" that the defendants had acted with scienter. 975 F.2d at 25. The court noted that one of the facts did, in fact, weigh in favor of a finding of scienter, but concluded that this single allegation was simply "not strong enough to bear the great overarching weight of factual inference the plaintiff wishes it to support." *Id.* at 27; *see Richardson by Richardson v. Richardson-Merrell, Inc.*, 857 F.2d 823, 830 (D.C. Cir. 1988) (evidence supporting plaintiffs'

[3] Amicus NELF also relies upon President Clinton's statement when vetoing the bill. NELF Br. at 10. President Clinton, relying on the Conference Report, concluded that the statute raised the pleading standard above Second Circuit levels. 141 Cong. Rec. H15214 (Dec. 20, 1995). Even if any conclusions could be drawn from such a statement, nothing in the President's statement suggests he was referring to the definition of "strong inference." Moreover, in overriding the veto, several Senators reiterated their view that the statute incorporated Second Circuit standards and that the Conference Report was not, in fact, the law itself. *See Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 169 (2d Cir. 2000); *Greebel*, 194 F.3d at 195 n.8 (citing the position of the SEC).

position not strong enough to permit jury to find in their favor). Indeed, the "reasonable person" or "reasonable jury" standard is sufficient to support liability after a full trial on the merits; it is difficult to imagine why Congress would have sought to impose a *higher* burden on plaintiffs at the pleading stage.

D. The Interpretations Offered by Petitioners and their Amici are Inconsistent with the Statutory Language and History

i. Petitioners' Interpretation is Without Support and Would Thwart Congress's Goals

Though Petitioners contend that a "strong inference" standard must go beyond a "reasonable person" formulation, they do not explain what formulation would be more appropriate. Instead, they offer various catchphrases: a complaint must "strongly show the promise or substantial merit in a plaintiff's claim of scienter," Pet. Br. at 23, or "paint a detailed picture of the facts that meaningfully tends to exclude the possibility of innocence and cogently shows that the plaintiff's claim that the defendant acted with scienter has substantial merit," Pet. Br. at 26, or present a "cogent picture of a substantially meritorious claim as to scienter," Pet. Br. at 31, or present a "cogent picture of a claim with significant merit," Pet. Br. at 30. Such standards are necessary, argue Petitioners, to effectuate Congress's goal of eliminating frivolous strike suits.

The most obvious flaw in Petitioners' argument is that they ignore the protections provided by the remaining portions of the PSLRA — several new pleading requirements, a discovery bar, new procedures for selecting lead plaintiffs, and new limitations on liability — *all* of which are geared toward eliminating frivolous actions or undue settlement pressures. Nowhere do Petitioners explain why the standard that is sufficient to support *liability at trial*, when taken in conjunction with these other measures, fails to prevent strike suits.

Indeed, it is plain that since the passage of the PSLRA, courts have stringently scrutinized complaints, demanding higher levels of detail than ever before. Securities fraud

complaints may be over 100 pages long, rely on the accounts of numerous former employees or other insiders, attach or specifically describe internal documents, or include expert analysis of data. *See, e.g., Nursing Home Pension Fund, Local 144 v. Oracle Corp.*, 380 F.3d 1226 (9th Cir. 2004); *Cabletron*, 311 F.3d at 30-31; *Scholastic*, 252 F.3d at 71-73; *MCI Worldcom*, 340 F.3d at 251-52. Petitioners do not explain why increasing these already onerous burdens will eliminate *even more* frivolous actions while still permitting well-grounded claims to proceed.

If anything, the interpretation offered by Petitioners seems intentionally designed to bar legitimate claims. For instance, Petitioners repeatedly urge this Court to allow plaintiffs to proceed only if their allegations of scienter have "substantial merit." Nowhere do Petitioners explain why Congress would have wanted merely "meritorious" claims to be dismissed at the pleading stage, let alone why Congress would have chosen the simple phrase "strong inference" to communicate such an intention.

Further, Petitioners' proposed formulation is entirely without support in the legislative history, securities case law generated either before or after the PSLRA, or even in other areas of law involving motions to dismiss or summary judgment. Petitioners have simply invented a new standard out of whole cloth that literally has no basis in the entirety of American law since at least the adoption of the Federal Rules of Civil Procedure. Not only would such a brand new standard create the very havoc that Congress sought to eliminate with the PSLRA, *see Advanta*, 180 F.3d at 532, but, once again, it defies logic to think that Congress intended to impose such a novel test by employing a phrase that already had an established, judicially-defined meaning.

ii. A "Strong Inference" is Not a Preponderance

Amicus United States contends that a "strong inference" is one that leads to a "conclusion" of scienter with a "high degree of confidence." U.S. Br. at 20. Amicus argues that the inference cannot be "borderline" or a "close call," *id.* at 21, and that a strong inference is lacking if there is a "substantial possibility"

that the defendants acted innocently, *id.* at 25. Though Amicus never says so explicitly, Amicus is urging that the phrase "strong inference" be construed to mean that the judge must make his or her own subjective determination as to whether the defendants committed fraud by *at least* a preponderance of evidence, if not by something approaching a "clear and convincing" standard. *See also* Amici Grundfest et al Br. at 16 (a "strong inference" is one that is "significantly" or "substantially more likely than not to be true.").[4] Just as with the formulation offered by Petitioners, such a construction is not suggested by the text of the statute, its legislative history, or the history of securities litigation prior to the PSLRA.

Congress knows the word "preponderance" and is fully capable of using it in a statute if it so desires. *See, e.g.*, 2 U.S.C. § 1606; 5 U.S.C. § 3328; 7 U.S.C. § 499a; 8 U.S.C. § 1160; 10 U.S.C. § 920; 11 U.S.C. § 362.[5] It is not plausible that Congress, intending to create a preponderance standard – let alone a "clear and convincing" standard – did not explicitly say so, but instead chose language that had a judicially-defined meaning that was *not* preponderance and had never been used to mean preponderance ever before. Petitioners' amici do not cite a single case decided before the PSLRA in which a "strong inference" of scienter for pleading purposes was equated with a preponderance of evidence, and offer no explanation for how Congress could have expected its use of the phrase "strong inference" would be so interpreted. The only way that amici attempt to support their argument in favor of the preponderance standard is by first attempting to divine Congress's intent from the legislative history. *See* U.S. Br. at 17-18. If amici are correct, it would mean that Congress, knowing that courts only turn to legislative history if the text of a statute is ambiguous, still

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[4] Amici Grundfest et al. also contend that an "inference" means a "conclusion" reached from facts. Grundfest Br. at 16. If Congress intended "inference" to mean "conclusion," it is unclear why the word "strong" would be used to temper the word "inference."

[5] A search on Westlaw produced 194 separate appearances of the word "preponderance" in the United States Code.

nonetheless communicated its new preponderance standard solely by inserting an ambiguous sentence in the Conference Report – a sentence that, itself, does not endorse a preponderance standard.

The interpretation offered by Petitioners' amici is particularly unlikely given its extreme departure from any standard ever before employed on motions to dismiss or even on summary judgment. Judges simply do not employ "preponderance" standards unless they are making their own findings of fact – procedures that, among other things, provide both parties an opportunity for discovery and to submit evidence. If Congress intended to radically alter the judge's role in evaluating complaints and motions to dismiss, it would have employed far less oblique language.

It is also unclear what sort of precedential force these proposed determinations will have, either in future cases or in later stages of litigation. Because the sufficiency of a pleading is a legal question, *see Hunter*, 2007 WL 509787, at *3, under these amici's recommended standard, any decision on the sufficiency of a securities fraud pleading would necessarily hold, as a matter of law, that, taking the allegations in a complaint as true, there is – or there is not – a preponderance of evidence of scienter. Presumably, this would mean that if the complaint survives the motion to dismiss and the evidence ultimately matches the allegations, a jury would be constrained in its ability to disagree with the judge or, in the appropriate instance, the determinations of an appellate court. The potential for mischief in such a doctrine is enormous.

Finally, even if these amici are correct that Congress intended for the judge to conduct a personal and subjective assessment of whether the defendants committed fraud, rather than to employ an objective, reasonable person standard, there is still no reason to equate a "strong" inference with a "preponderance." There is no reason to believe that Congress only intended complaints to pass muster if, at the pleading stage, the plaintiffs already had amassed enough evidence to prove

their claims to a judge's satisfaction. Rather, a "strong" suspicion of fraud may be created even if the judge is not ready, on the pleadings, to say conclusively that the defendants acted intentionally or recklessly. To see why, it is important to remember that, generally, we presume that most companies do not commit fraud. Because fraud is relatively rare, if, on the pleadings alone, prior to discovery, there is a thirty or forty percent chance that fraud may have occurred, that is a "strong" inference, taken in context. In other words, whether allegations raise a "strong inference" of fraud must be viewed in light of the base rates of fraud. Certainly, if plaintiffs have made particularized allegations that the defendants issued materially false statements, and if plaintiffs have shown they suffered losses as a result – all pleading requirements under the PSLRA, *see Dura Pharm. v. Broudo*, 544 U.S. 336, 347 (2005); 15 U.S.C. § 78u-4(b)(1) – if they then additionally show that there is a forty percent chance that those false statements were issued intentionally or recklessly, those plaintiffs at least should be permitted access to discovery.[6] At bare minimum, plaintiffs who make such a showing have demonstrated that they are not on the sort of "fishing expedition" that the PSLRA was designed to prevent. H.R. Conf. Rep. No. 369, *supra*, at 37.

III. PETITIONERS' INTERPRETIVE PRINCIPLES ARE AT ODDS WITH THE GOALS OF THE PSLRA

Petitioners contend that the "strong inference" standard requires adherence to three "principles." These principles are both misguided and unnecessary.

A. The Complaint Should be Construed in the Light Most Favorable to Plaintiffs

For over fifty years, it has been an integral part of federal procedure that on a motion to dismiss, a court accepts all factual

[6] Even outside the securities context, the phrase "strong inference" has been used to mean less than a preponderance. *See United States v. Twenty (20) Cashier's Checks*, 897 F.2d 1567, 1570 (11th Cir. 1990) (despite strong inference to the contrary, there was no probable cause to forfeit property belonging to sisters of convicted drug trafficker).

allegations as true and construes the complaint in the light most favorable to the plaintiff. *See Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). However a "strong inference" is defined, nowhere does the PSLRA instruct judges to abandon these blackletter principles and cease to draw even *reasonable* inferences in plaintiffs' favor. Instead, the statute merely provides that although plaintiffs continue to benefit from reasonable inferences, ultimately, those inferences, taken in their totality, must create a "strong" inference. *See In re AMDOCS Ltd. Sec. Litig.*, 390 F.3d 542, 547 (8th Cir. 2004); *Garfield v. NDC Health Corp.*, 466 F.3d 1255, 1264 (11th Cir. 2006); *Tricontinental Indus., Ltd. v. PricewaterhouseCoopers, LLP*, 475 F.3d 824, 841 (7th Cir. 2007); *Ezra Charitable Trust v. Tyco Int'l, LTD*, 466 F.3d 1, 6 (1st Cir. 2006).

Any other interpretation would further risk creating insurmountable barriers for meritorious claims. For instance, Amicus United States urges that each fact be evaluated to determine whether there exists a reasonable, and innocent, inference in addition to whatever plausible inferences exist in plaintiffs' favor, and weigh the inferences accordingly. U.S. Br. at 24. But such an approach ignores what the circuits routinely recognize: that even weak inferences, considered in their totality, can create a strong inference of wrongdoing. *See Phillips v. Scientific-Atlanta*, 374 F.3d 1015, 1017 (11th Cir. 2004); *Cabletron*, 311 F.3d at 39; *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 431 (5th Cir. 2002); *Green Tree*, 270 F.3d at 660; *Rothman v. Gregor*, 220 F.3d 81, 92 (2d Cir. 2000). And though a single fact may have innocent explanations, those innocent explanations may seem less plausible as additional facts are added to the mix. Indeed, at trial, plaintiffs would hardly be expected to prove their case by putting forth solitary pieces of evidence; they would instead expect to put on multiple pieces of evidence, which, taken together, proved their claims. *Cf. Bourjaily v. United States*, 483 U.S. 171, 179-80, (1987) ("The sum of an evidentiary presentation may well be greater than its constituent parts."). Amicus's proposed standard would,

once again, set a *higher* bar at the pleading stage than plaintiffs would be expected to meet in later stages of litigation.

Additionally, both Petitioners and their amici urge that courts draw inferences in defendants' favor when such inferences seem reasonable. Pet. Br. at 35; U.S. Br. at 24. Apparently, they would have judges act as juries: judges would be required to make their own determinations as to the most plausible explanations for each allegation, with no evidence on which to base their rulings, and no matter what reasonable disagreement might exist. Complaints would be dismissed based solely on the judge's own personal evaluations of which of several reasonable inferences was the most plausible. Once again, then, Congress's use of the phrase "strong inference" – which had been in common judicial usage since 1979 – coupled with its demand for "particularity" – language taken straight out of the federal rules – would be read by Petitioners to create a radically new system of pleading, wholly departing from established procedures as they have existed for over fifty years. Such an interpretation simply appears nowhere in the language of the statute or its legislative history.

A more plausible interpretation is that Congress intended its "strong inference" requirement to be read in conjunction with traditional notions of pleading, which, even for complaints subject to the heightened requirements of Rule 9(b), still afford plaintiffs the benefit of all reasonable inferences. *See, e.g.*, *Allwaste, Inc. v. Hecht*, 65 F.3d 1523, 1527 (9th Cir. 1995); *Kowal v. MCI Comms. Corp.*, 16 F.3d 1271, 1276 (D.C. Cir. 1994); *Schiffels v. Kemper Fin. Servs.*, 978 F.2d 344, 346 (7th Cir. 1992). No matter how the phrase "strong inference" is interpreted, it is indisputable that Congress based the statute at least in part on contemporary interpretations of Rule 9(b). *See* H. Conf. Rep. No. 369, *supra*, at 41. Congress would have expected that complaints would be evaluated as they always had been under that rule.

The danger of Petitioners' approach can be seen in the very example they use to illustrate their new standard. Petitioners

contend that facts "directly at odds" with the alleged fraudulent scheme should be interpreted to weaken inferences of scienter, and offer as an example the fact that in this case, the defendant corporation admitted to lessened demand for its products during the class period. Pet. Br. at 36. In Petitioners' view, these disclosures cannot be reconciled with a scheme to mislead the public through overstated revenue projections.

However, it should come as no great surprise that not all frauds are planned with Moriarty-like precision. *See Asher v. Baxter*, 377 F.3d 727, 728 (7th Cir. 2004) ("[T]he securities laws forbid foolish frauds along with clever ones."). It takes no leap to imagine that a company might falsely characterize the impending demand for its products in the irrational hope that it might eventually be able to turn things around. It is equally plausible that as the day of reckoning approached, the company would realize that its fraud would inevitably be disclosed, and would attempt to minimize the problem with a series of incremental disclosures. *Cf. Green Tree*, 270 F.3d at 662 (accepting allegations that defendants raced against the clock in hopes that business would turn around before the fraud could be revealed). Surely such inferences are at least plausible enough to allow the ultimate factfinder to make the final determination – with the benefit of, among other things, documentary and testimonial evidence. Perhaps more importantly, if courts were to create a blanket rule that incremental, voluntary disclosures conclusively rebut all but the most overwhelming allegations of scienter, companies would quickly learn to insulate themselves from liability, no matter how great their frauds, with an eleventh hour confession.

B. "Motives" Should Not Be Narrowly Defined

Petitioners' next "principle" is that the inferences of scienter are diminished where there is no motive for fraud. Pet. Br. at 36. As an example, they claim that in this case, plaintiffs have not alleged that Defendant Notebart personally benefited from any fraud, and have not alleged that Tellabs had a pressing need for a high stock price, such as an impending merger. Pet. Br. at 50. From this, they conclude that there was no motive at all, and that any inference of scienter is correspondingly weakened.

Id. Petitioners fail to distinguish between the absence of *any* motive, and the absence of a motive that, *in itself*, is so compelling that it contributes to an inference of scienter.

As discussed further below, courts will not draw inferences of intent or recklessness from the mere fact that a defendant might have had an "ordinary" motive to commit fraud, such as a desire to increase the corporate stock price, or, in the case of an individual, to obtain a garden-variety end-of-year bonus. Because every corporation will benefit in some way from an increased stock price and most executives receive performance-based compensation, such factors do not, without more, create an inference of fraud. *See Novak*, 216 F.3d at 307-08. However, when the stakes are unusually high – for instance, when a compensation package is particularly large – that fact can contribute to an inference of fraud. *See Green Tree*, 270 F.3d at 661.

The existence of an "ordinary" motive is not equivalent to an *absence* of motive. This Court has observed in the context of antitrust law that some alleged schemes are so economically irrational that it is highly implausible that any defendant would have engaged in them. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589-92 (1986). Even if this principle applies to securities fraud complaints, it will be a rare case when a defendant literally could not have benefited from an alleged fraud. Even mundane motives might spur fraud; it is simply that where only "mundane" motives exist, they do not contribute much to inferences of scienter. *See Green Tree*, 270 F.3d at 663-64. It does not mean that such run-of-the-mill motives actually work *against* an inference of scienter.

Moreover, it must be recalled that *Matsushita* involved allegations of an intentional, planned, years-long conspiracy, something that was particularly unlikely given the remote possibility that the defendants would ultimately profit. 475 U.S. at 590. Plaintiffs alleging securities fraud, by contrast, need only prove recklessness – and reckless actors are not necessarily known for their planning abilities and foresight. Reckless actors may gamble on being able to cover up their fraud until the economy turns around,

see Green Tree, 270 F.3d at 662; as the losses mount, bigger gambles may be required to continue to conceal the wrongding, *see* Donald C. Langevoort, *Agency Law Inside the Corporation*, 71 U. Cin. L. Rev. 1187, 1218 (2003). Reckless actors may bow to personal pressures. *See AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 205 (2d Cir. 2000). Some of the most infamous frauds in recent years may have resulted from corporations that encouraged and cultivated climates of excessive recklessness and risk taking. *See* Lynn E. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 Rutgers L.J. 1, 45-51 (2003).

In this case, plaintiffs may not have alleged the existence of a motive so extraordinary that, by itself, it contributes to an inference of scienter, but the alleged scheme is not economically irrational in the *Matsushita* sense. Tellabs and its employees would have reaped the benefits associated with a higher stock price, and it is plausible that defendants might have recklessly sought to mislead the market about current demand in hopes that the underlying reality would catch up to their public optimism. "Although these contentions do not amount to a showing of an unusual, heightened motive . . . , they at least paint a rational and plausible picture" of why the defendants might have undertaken the fraud. *Green Tree*, 270 F.3d at 665.

Indeed, the very fact that Petitioners offer this argument – that they contend that the absence of "heightened" motive for fraud should actually weigh in their favor – highlights the danger of counseling courts to choose among competing reasonable inferences.

C. There Can Be No Blanket Rule Regarding the Treatment of Inferences in Equipoise

i. Precedent Developed in the Antitrust Context is Inapplicable

In an ordinary motion to dismiss or for summary judgment, reasonable inferences must be drawn in favor of the nonmoving party. *See Liberty Lobby*, 477 U.S. at 255; *Ezra Charitable*

Trust, 466 F.3d at 5-6. If there is ambiguity in the proper interpretation of evidence, the case goes forward. *See Douglas v. York County*, 360 F.3d 286, 290 (1st Cir. 2004). Petitioners, however, relying almost entirely on two antitrust cases decided on summary judgment, argue that when allegations are "equally consistent with innocence as they are with culpability," there can be no strong inference of scienter. Pet. Br. at 37. These cases are unique to antitrust law and should not be applied here.

In *Matsushita* and *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984), this Court held that in antitrust actions, plaintiffs cannot meet their burden of production by alleging "conduct as consistent with permissible competition as with illegal conspiracy." *Matsushita*, 475 U.S. at 588. But nothing in *Matsushita* supercedes the ordinary principle that reasonable inferences are to be drawn in favor of the nonmoving party even at the summary judgment stage – let alone on a motion to dismiss. This is because although it is indisputable as a matter of logic that when a fact is truly "equally" consistent with legal behavior and with illegal behavior, it cannot be said to weigh in either party's favor, it is difficult to determine when that point has been reached. *See* Note, *Summary Judgment and Circumstantial Evidence*, 40 Stan. L. Rev. 491, 504 (1988). Ordinarily, there may be a reasonable range of opinions as to whether the particular fact is, truly, "equally" consistent with both parties' contentions. When a jury may reasonably believe that the fact is actually more consistent with one party's version of events than another's, the case must go forward, even if the judge believes that the evidence is in equipoise. *See id.*

Antitrust laws, however, are designed to foster competition, and the line between legal, competitive behavior and illegal, anticompetitive behavior is generally drawn based on economic theory. *See generally* Phillip E. Areeda and Herbert Hovenkamp, 1 *Antitrust Law: An Analysis of Antitrust Principles and their Application* (2006). That is, in the antitrust context, behavior crosses into illegality when there has been a determination (either for a class of cases, or under a "rule of reason" analysis) that

the behavior is more likely to do economic harm than good. *See Texaco Inc. v. Dagher*, 126 S. Ct. 1276, 1279 (2006). In *Matsushita* and *Monsanto*, this Court was particularly sensitive to such concerns, noting that just about any conduct that fell short of actually violating the antitrust laws was not only not prohibited, but might, in fact, be precisely the kind of healthy competitive behavior that Congress sought to protect. *See Matsushita*, 475 U.S. at 594; *Monsanto*, 465 U.S. at 761-63. In this context, the precise facts on which the plaintiffs relied to prove the existence of a conspiracy were not only not illegal, but actually *beneficial* behaviors – particularly in the case of *Matsushita*, where the essence of the conspiracy alleged was to *lower* prices. In such a situation, the Court – as a matter of public policy – was unwilling to risk deterring pro-competitive behavior by allowing a jury to rely on the very beneficial conduct that the laws were designed to protect as evidence of illegality. *See Matsushita*, 475 U.S. at 588 ("[A]ntitrust law limits the range of permissible inferences from ambiguous evidence in a § 1 case."). Additionally, in the case of *Matsushita*, this Court believed that various economic aspects of the scheme made it extremely implausible, further heightening the need for additional evidence. *See Matsushita*, 475 U.S. at 589-92.

The securities laws are different. Although Congress wished to encourage companies to make various voluntary disclosures, the line between legal conduct (truthful disclosures), and illegal conduct (untruthful disclosures) is not based on an economic policy judgment in the same way that antitrust lines are drawn. Additionally, the types of facts upon which plaintiffs typically rely to support an inference of scienter are not the *statements themselves* (i.e., the conduct Congress wished to encourage), but are other sorts of facts – such as reports that problems were common knowledge within the company, *see City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 684-87 (6th Cir. 2005), the existence of profits from insider trading, *see Scholastic*, 252 F.3d at 74-75, or accounting violations of extreme magnitude, *In re Daou Sys.*, 411 F.3d 1006, 1022 (9th Cir. 2005). These behaviors may not be *illegal* when undertaken

without fraudulent intent, but neither has Congress gauged them beneficial or sought to encourage them. Therefore, there is no reason to set a general rule that the determination as to *when* evidence *is in fact* in equipoise must be taken out of the hands of the jury, let alone taken out of the jury's hands at the pleading stage, before discovery.

To be sure, in some specific situations, the banality of the conduct alleged may be so plain that there can be no reasonable disagreement even as to the probabilities themselves. That is, there may be specific types of situations where there is no room for any disagreement as to whether the conduct is equally consistent with innocent as with culpable conduct. Courts have recgonized this principle for years, well before the passage of the PSLRA, and have developed a variety of tools for recognizing the presence of such allegations and refusing to allow them to contribute to an inference of scienter.

For instance, in developing its "motive and opportunity" test, the Second Circuit eventually settled on the principle that inferences of scienter could not be drawn from motives "possessed by virtually all corporate insiders" such as "the desire to maintain a high stock price in order to increase executive compensation." *Novak*, 216 F.3d at 307; *see also Green Tree*, 270 F.3d at 655-57 (explaining the evolution of the Second Circuit's test). This principle has been uniformly followed by other circuits, *see, e.g., Kushner v. Beverly Enters., Inc.*, 317 F.3d 820, 829 (8th Cir. 2003); *Cabletron*, 311 F.3d at 39; *GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 237 (3d Cir. 2004); *Ottman*, 353 F.3d at 352, because it is indisputable that most, if not all, corporate executives stand to benefit economically from an increase in their company's stock price. Similarly, scienter cannot be inferred from an auditing firm's desire to earn fees. *See, e.g., Tricontinental*, 475 F.3d at 841. However, if the plaintiff shows that there was something unusual about a particular compensation package that takes it out of the norm, that fact may at least contribute to the scienter inquiry. *See, e.g., Green Tree*, 270 F.3d at 661.

All courts agree that a defendant's sales of stock prior to disclosure of unfavorable information will not support an inference of scienter unless the plaintiff alleges specific facts demonstrating that the sales were unusual in magnitude or timing. *See, e.g., In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256 (3d Cir. 2006). These courts reason that executives sell stock for a variety of reasons, including imminent departure from the company, *see, e.g., In re K-Tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 896 (8th Cir. 2002), or simply because they sell on a regular basis, *in re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1423 (3d Cir. 1997). Once again, because there can be no disagreement as to the banality of stock sales by corporate executives, no reasonable factfinder could rely solely on such sales to infer scienter.

Several other similar rules have been agreed upon by all of the circuits,[7] with the caveat that such allegations will contribute to the inference of scienter when there is something unusual about the situation that takes it out of the realm of ordinary corporate conduct. *See, e.g., Scholastic*, 252 F.3d at 77; *Daou*, 411 F.3d at 1022; *Advanta*, 180 F.3d at 539. But, as should be evident from these examples, there can be no general, across-the-board rule that facts as likely to be associated with legal conduct as with illegal conduct shall be disregarded. Leaving aside the obvious point that an apparently innocent fact may seem less so when considered in conjunction with other facts, *see Phillips*, 374 F.3d at 1017, it is only in the context of particular types of allegations that a court can even begin to evaluate whether, in fact, there can even be reasonable disagreement over these antecedent probabilities.

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[7] For example, courts will not presume fraud from the existence of accounting violations alone, *e.g., DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002), or presume knowledge from corporate title, *e.g., Suprema Specialties*, 438 F.3d at 282, or infer fraud solely from the fact that a corporation experienced losses after making optimistic statements, *e.g., DiLeo v. Ernst & Young*, 901 F.2d 624, 627-28 (7th Cir. 1990).

ii. The PSLRA Does Not Replace the Principle that a Plaintiff is Master of His Complaint

Extrapolating from their two antitrust summary judgment decisions, Petitioners rely on pleading precedents issued nearly 100 years before the adoption of the Federal Rules of Civil Procedure to argue that plaintiffs should be required to plead in their complaint even facts adverse to their allegations. Pet. Br. at 38-39.[8] As an example of the type of "improper" pleading that Petitioners seek to eliminate, they point to plaintiffs' allegations that a report unfavorable to Tellabs was generated in early 2001. Pet. Br. at 46. Relying in part on the existence of this report, the Seventh Circuit drew the inference Defendant Notebart was aware of certain unfavorable facts prior to making contrary public statements in February 2001. Petitioners argue that because a report alleged to have issued in "early 2001" may have been completed after Notebart spoke in February – in which case no inference of fraud can be drawn – plaintiffs should not be permitted to "strategically" delete the precise date of the report. *See id.*

First, as a general matter, even if the report issued after Notebart spoke, that does not mean that no inference can be drawn. Tellabs had commissioned the report and presumably cooperated with its authors as it was being prepared; Tellabs employees may well have been privy to the report's conclusions prior to its formal completion. *Cf. Greenstone*, 975 F.2d at 26 (knowledge of legal problems may be inferred when a lawsuit follows in close proximity to an allegedly false statement). If such were the case, the inferences of knowledge might be weakened, but would not entirely disappear.

Leaving this point aside, as no formal discovery has yet occurred, Petitioners do not explain why they believe the date of the report is in plaintiffs' possession, and offer no suggestions for how a court is to distinguish "strategic" ambiguity from plaintiffs' own lack of complete knowledge. Petitioners do not explain why Rule 11 would not be sufficient to deter plaintiffs

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[8] It should be noted that even Amicus United States disagrees with Petitioners' position. U.S. Br. at 25.

from actively seeking a court to accept inferences that the plaintiffs know, for a fact, to be untrue. *Cf. Green Tree*, 270 F.3d at 668. Finally, Petitioners do not explain how plaintiffs themselves are to determine, at the drafting stage, what is improper "strategic" ambiguity and what is simply the ordinary exercise of their privilege to draft their complaints so as to present their claims in the best possible light. Once again, Petitioners would have this Court conclude that by incorporating language with a pre-existing legal meaning into a new statute, Congress sought a drastic reworking of the Federal Rules of Civil Procedure in a manner that has never been contemplated by any modern court.

IV. THE PSLRA SHOULD BE INTERPRETED WITH AN UNDERSTANDING OF THE VITAL ROLE PLAYED BY PRIVATE SECURITIES LITIGATION IN OUR REGULATORY SYSTEM

Private litigation is a "necessary supplement" to public enforcement of the securities laws. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). According to the congressional testimony of then-SEC Chairman Arthur Levitt, "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws." *Common Sense Legal Reform Act: Hearing Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong. 2 (1995) (prepared statement). In the wake of recent accounting scandals in 2001 and 2002, Congress reiterated the importance of private securities actions when enacting the Sarbanes-Oxley Act of 2002 which, among other reforms, extended the statute of limitations for securities fraud cases. *See* Pub. L. No. 107-204, Title VIII, § 804(a)(b) and (c).

Private enforcement is necessary because the SEC simply does not have the resources to police the entire market. For instance, last year, the number of enforcement cases brought by the agency declined 9% as the agency grappled with staffing cuts and a budget crunch. *See* Carrie Johnson, *SEC Enforcement Actions Decline 9%*, Wash. Post, Nov. 3, 2006, at D3. Private

actions often yield larger recoveries for defrauded investors than SEC enforcement suits. For instance, the SEC's Enron-related settlement fund holds approximately $440 million; the private actions, in contrast, have achieved a recovery of more than $7.3 billion. *Compare* http://www.sec.gov/divisions/enforce/claims/enron.htm *with* http://www.universityofcalifornia.edu/news/2006/sep21a.html (last visited 3/5/2007). The SEC recovered $750 million for Worldcom investors, while the private litigation recovered over $6 billion. *Compare* http://www.worldcomvictimstrust.com *with* http://www.worldcomlitigation.com/html/citisettlement.html (last visited 3/5/07). And in the pending Global Crossing class action, investors have already recovered $444 million; the SEC, by contrast, has not recovered any monies for investors. As Amicus United States concedes, "[M]eritorious private actions are an essential supplement to criminal prosecutions and civil enforcements." U.S. Br. at 1.

The PSLRA has also largely accomplished Congress's goal of eliminating frivolous litigation. Since its passage, dismissals on the pleadings have nearly doubled. *See* NERA Economic Consulting, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, at 4 (Jan. 2007). The number of filings has declined as well: In 2006, securities fraud lawsuits fell to a record low. *See* Cornerstone Research, *Securities Class Action Case Filings – 2006: A Year in Review*, at 1 (Jan. 2007). Professor James D. Cox at Duke Law School studied 600 securities class actions filed since the passage of the PSLRA and opined that in the wake of the new rules, it was difficult to find any that were abusive or malicious. *See* Stephen Labaton, *Businesses seek new protection on legal front*, N.Y. Times, Oct. 29, 2006, at A1.

Moreover, since the passage of the PSLRA, more institutional investors – public pension funds in particular — have taken on lead roles, precisely as Congress envisioned. *See* Stephen J. Choi, Jill E. Fisch and A.C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private*

Securities Litigation Reform Act, 83 Wash. U.L.Q. 869-905 (2005). These investors, such as Amici, not only play a pivotal gatekeeping role in weeding out strike suits, but they also demand corporate governance reforms in addition to monetary recoveries as part of their settlements. *See generally* Michael Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions,* St. John's Univ. School of Law, Legal Studies Research Paper Series, Paper #06-0055 (Oct. 2006)(avail. at http://ssrn.com/abstract=938722); *see also In re Cendant Corp. Litig.*, 264 F.3d 201, 246-47 (3d Cir. 2001) (approving such a settlement). The presence of institutional investors leads to larger recoveries and lower attorneys' fees, exactly as Congress predicted. *See generally* Perino, *supra*. In short, with the PSLRA, Congress accomplished exactly what it set out to do. Frivolous lawsuits have been reduced or eliminated; institutional investors have taken control of shareholder litigation, and investors have benefited as a result. If pleading standards are heightened further, as Petitioners demand, all that will result is that more meritorious actions – the kind that Congress intended to preserve as a crucial aspect of our regulatory system – will be barred at the courthouse door.

CONCLUSION

The Seventh Circuit's "reasonable person" standard for determining whether a complaint creates a "strong inference" of scienter comports with the consistent interpretation that had been given to those words for 25 years prior to the passage of the PSLRA. The alternative standards offered by Petitioners and their amici not only represent a wholesale departure from existing precedent, but would place onerous burdens on plaintiffs bringing legitimate claims. For these reasons, the Seventh Circuit's decision should be affirmed.

Respectfully submitted,

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